IN THE

Supreme Court of the United States

OCTOBER TERM, [redacted] 1925

CHARLES V. DUFFY, former Collector of Internal Revenue,
Petitioner,

vs.

THE MUTUAL BENEFIT LIFE INSURANCE COMPANY,
Respondent.

ANSWER AND BRIEF OF RESPONDENT.

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Supreme Court of the United States

OCTOBER TERM, 1924.

CHARLES V. DUFFY, former Collector of Internal Revenue, *Petitioner,* *vs.* THE MUTUAL BENEFIT LIFE INSURANCE COMPANY, *Respondent.*	*No.*

Answer and Brief of Respondent.

Statement of Case.

Respondent is a mutual life insurance company with no capital stock and no stockholders (Complaint, Record, pp. 2-3).

The page references are to the printed record used in the Circuit Court of Appeals.

All persons who insure with the company become members of the corporation. Its business is conducted by directors chosen by and from the members (Charter, Sec. 2; Record, p. 27).

Like practically all life insurance companies, respondent conducts its business on the level premium plan, whereby during the policy period that part of the premium to be paid annually to meet death losses is an average of the low natural premiums in the earlier years and the high natural premiums in the later years of life, thus avoiding the necessity of prohibitive premiums as the probability of dying increases with advancing years.

The average premium so estimated, increased by an allowance for cost of conducting the business, is uniform throughout the life of the policy. (Fully explained Complaint, Record, p. 3 bottom and p. 4 top; also in *Mutual Benefit Life Insurance Company* v. *Herold*, 198 Fed. 199, at 202 bottom.)

The sums in excess of the amount required to pay death losses (technically known as the cost of insurance) in the earlier years, augmented by interest, constitute a "reserve" which serves to maintain the insurance in the later years when the stipulated level premium would otherwise be insufficient to meet the current cost of insurance. This reserve is usually denominated the "legal" reserve because it is required by law.

At the end of each year the excess of income over death losses and other disbursements is ascertained, and after setting aside so much thereof as is required by law for the increase in the policy reserve, each policy-holder's share in the balance is ascertained and returned to him either in cash or by credit upon his next annual premium, as he may elect (Complaint, Record, p. 4).

The laws of all the states require of every life insurance company as a condition precedent to the continued transaction of business that its assets shall not be less than the legal reserve (Complaint, Record, pp. 4, 5).

The amount of legal reserve is calculated annually by the supervising commissioners and by the companies, and is based on an assumed rate of mortality formulated from long experience and an assumed rate of income from invested funds conservatively estimated at a low rate.

Theoretically, a life insurance company answers all the requirements of law and of sound practice if it maintains assets sufficient at the end of each year to equal the legal reserve then calculated.

Practically, however, conservative companies maintain assets somewhat in excess of the "legal" reserve, in order to meet contingencies, such as a fall in market value of securities, or an abnormal increase in mortality due to war and pestilence, both of which were experienced to an unusual degree in connection with the late war. This margin of safety in assets over reserve requirements respondent denominates its "contingency reserve." The amount of it is in the discretion of the directors, based on experience and forecast.

These two reserves—one required by law, the other discretionary—comprise the entire assets of the respondent, which are invested under statutory restrictions in government, municipal, railroad and utility bonds, bonds secured by mortgages on real estate, loans on collateral and to policy-holders, and a necessary office building. The average rate of interest on respondent's invested assets is, and for many years has been less than six per cent. per annum (Complaint, Record, p. 3).

Respondent's assets are not segregated or earmarked or specially allocated to either of these reserves. Nor are they separately invested. There is no requirement of law or sound practice that requires such allocation, nor is it practicable in view of the fluctuating market values of the assets, which would require a constant shifting of assets from the legal reserve to the contingency reserve and *vice versa*. The assets, therefore, constitute one general fund. The interest earned on all its securities except those which, because of their character, are specifically exempt from tax, is included in respondent's return of gross income for federal income tax purposes (Complaint, Record, p. 4, l. 31, to p. 5, l. 2).

On January 1, 1917, respondent's assets amounted to $198,713,925 (Record, p. 13) and its legal reserve was computed at $186,258,796. Of this latter sum about $70,000,000 consisted of premiums paid in by its policy-

holders, and about $116,000,000 consisted of interest earned by its invested funds (Complaint, Record, p. 6).

In 1909, Congress by the Corporation Excise Tax Law (36 Stat. 112, C. 6, Sec. 38, U. S. Comp. St. Supp. 1911, p. 946), imposed a tax on life insurance companies based upon their income. In its application to respondent, certain questions arose which were considered by the United States District Court for New Jersey in the case of *Mutual Benefit Life Insurance Company* v. *Herold, Collector,* 198 Fed. 199, affirmed by the Circuit Court of Appeals on the opinion below, 201 Fed. 918, and considered in this court on petition for writ of certiorari, 231 U. S. 755, the application being denied. In that case the opinion of the lower court set forth fully the principles of mutual life insurance as practiced by respondent and other similar insurance companies, the method of determining premiums and reserves and the return to policyholders of any excess payments, and ascertained that these methods were intended to and did result in furnishing insurance to policy-holders *at cost,* and cited with approval cases holding that gains and profits were foreign to the principles of mutual life insurance.

In the Corporation Excise Tax Law of 1909, the annual additions to the legal reserves of life insurance companies were excepted from taxable income, apparently because they were additions to capital assets contributed by the policy-holders either in their premiums or in the interest earnings therefrom. This principle has been continued in all the income tax laws enacted under the income tax amendment to the Constitution.

The "War Excess Profit Tax" Law.

After this country entered the World War, Congress on October 3, 1917, passed an act "to provide revenue to defray war expenses" and adopted the method pursued by the other belligerent countries of imposing a heavy

tax on those industries which were realizing unusual profits on account of war activities.

The purpose was clearly expressed in the Senate Finance Committee's report of August 6, 1917 (Calendar No. 106, Sixty-fifth Congress, First Session, Report No. 103, Senate, pp. 3 and 4) as follows:

> "After mature consideration your committee reached the conclusion that, in view of the large amount to be raised and the enormous war profits, amounting to nearly $3,000,000,000, shown by the income-tax returns of corporations for 1916, which amount will undoubtedly be increased for the year 1917, due in the main to war and war conditions, $562,000,000 was not an unreasonable additional amount to ask *from the industries whose earnings have been so greatly augmented by* the conditions which made necessary the call for this additional revenue.
>
> * * * * * *
>
> "Your committee accordingly proposes the repeal of the existing war-profits tax law, and the substitution for both it and the additional war-profits tax passed by the House of a tax upon a basis similar to that followed by the European countries in which such taxation has been carried out with marked success. The committee proposes, instead of an *excess*-profits tax, a *war*-profits tax. In general, it proposes to make the basis of the tax the difference between the profits of the pre-war period and the profits of the taxable year. We take by taxation, directly or indirectly, for the purposes of war, a part of the *extra gains which war itself has caused.*"

This purpose was attributed to the law by this court in *La Belle Iron Works* v. *U. S.*, 256 U. S. 377, at 386, as follows:

> "Reading the entire language of Section 207 in the light of the circumstances that surrounded the passage of the Act, we think its meaning as to 'invested capital' is entirely clear. The great war in Europe had been in progress since the year 1914,

> and the manufacture and export of war supplies and other material for the belligerent Powers had stimulated many lines of trade and business in this country, resulting in large profits as compared with the period before the war, and as compared with ordinary returns upon the capital embarked.
>
> "The United States had become directly involved in the conflict in the Spring of 1917, necessitating heavy increases in taxation; at the same time manufactures and trade of every description were rendered even more active, and in certain lines more profitable, than before, so that the unusual gains derived therefrom formed a natural subject for special taxation."

By that law, in addition to the ordinary income tax to which respondent and all other corporations had been subjected, a provision was added, specifically denominated a "war excess profits tax," as recommended by the Senate Committee.

To determine what were "war excess profits," Congress decided that a reasonable profit was between seven and nine per cent. of the invested capital, and for comparison with pre-war period of profit defined invested capital in the case of corporations as including "actual cash paid in" * * * and "paid in or earned surplus and undivided profits used or employed in the business," excluding assets exempt from the ordinary income tax, also borrowed money. The term "corporation" was defined (the same as in the general income tax law) as including "insurance companies."

There is abundant evidence in the scheme of the act that Congress had in mind only corporations organized for profit, and not mutual life insurance companies. However, as the latter were not expressly excepted, the revenue authorities required respondent, in addition to its return of ordinary taxable income for the year 1917, upon which it showed a net income of $1,800,000 and a tax of $108,500 (Complaint, Record, p. 8), to make a return

under the War Excess Profits Tax Law. In making its additional return for 1917, under the War Excess Profits Tax Law, and applying its provisions by analogy to a mutual company, respondent reported, as its invested capital, the total amount of "actual cash paid in" by its members (analogous to stockholders) and the interest that had been earned, as its "capital, surplus and undivided profits" at the beginning of the taxable year, amounting to $198,712,831, which, after deducting about $4,000,000 of tax-exempt securities as required by the act, and adding about $8,000,000 for increase of invested capital during the current year, made respondent's invested capital for the year in question $202,685,846 (Complaint, Schedule H, Record, p. 20). As respondent's taxable income for that year was $1,808,000, it did not approach the seven per cent. allowed by the act on invested capital, and the return showed no war excess profits tax due.

The Disputed Assessment.

Notwithstanding all the invested capital as so returned represented actual cash previously paid in by the members of the corporation, or accumulated earnings therefrom, the Commissioner of Internal Revenue, in an effort to subject respondent to a war excess profits tax, arbitrarily amended its return by deducting from its invested capital as returned, a sum equal to its legal reserve, leaving as its invested capital only the small residue of contingency reserve held by it as a margin of safety in support of its legal reserve. This deduction left only $14,719,000 as respondent's invested capital for the purpose of the act, or about seven per cent. of its earning assets. Allocating thereto all of the taxable income of $1,800,000 earned by all of the $200,000,000 of respondent's assets, the apparent income on such artifically determined invested capital was necessarily in excess of the maximum of nine per cent. permitted by the act, and on that basis respond-

ent was subject to a war excess profits tax of $83,779.70 for the year 1917, which on June 10, 1920, the Commissioner assessed against the respondent (Complaint, Record, p. 8).

Thus, by a stroke of the pen, the plaintiff—a benevolent institution engaged exclusively in the business of furnishing to its members life insurance at cost, with no purpose or opportunity to make gains or profits of any kind, but necessarily subjected by the war to unusual losses—was transformed into a "war profiteer" and condemned to pay $83,000 in addition to the $108,000 it had paid as ordinary income tax.

Natural Construction of the Act.

This deduction of respondent's legal reserve from its invested capital seemed unjustifiable. In the *La Belle Iron Works* case, this court held that the purpose of Congress in its definition of invested capital for the purpose of the act was to determine such capital on the basis of *cash* contributed or accumulated, as distinguished from estimated values of earning capital (256 U. S., p. 387), thus avoiding confusing questions that would naturally arise and "guarding against inflated valuations."

It seemed equally evident that Congress by the "non-inclusion clause" (Sec. 207, par. 2) intended merely to co-ordinate the "excess profits tax" with the ordinary income tax and limit the capital on which the new act was based to invested assets that yielded income taxable under the main act. To accomplish that purpose it was logical and necessary to deduct from invested capital "assets, the income from which is not subject to the tax imposed by this title," and likewise borrowed money the interest on which is deducted from gross income in determining the net taxable income.

This is the natural construction of the clause, and it bears no suggestion or implication that it was intended to exclude from capital account income-producing assets of the plaintiff constituting its legal reserve, other than its tax-exempt bonds. These were deducted in plaintiff's original return.

There is nothing in the scheme of the act to indicate that Congress intended any other definition of capital than what is implied in the statement in *Merchants Loan & Trust Co.* v. *Smietanka*, 255 U. S. 509, at 518:

> "Income may be defined as the gain derived from capital, from labor, or from both combined."

Conversely, in non-industrial companies, capital is that from which income is derived. The only limitation upon that definition intended by Congress in the two clauses in question is that for the purpose of the act capital is valued on a *cash* basis, and assets that yield non-taxable income are deducted.

Respondent therefore paid the additional assessment under protest and immediately began suit to recover the amount so paid. This suit resulted in a judgment in the respondent's favor entered February 26, 1924 (Record, p. 68), which was later affirmed by the United States Circuit Court of Appeals for the Third Circuit on March 2, 1925. For opinion in District Court, see 295 Fed. Rep. 881, on appeal, 3 Fed. Rep. 2d series, p. 1020.

In the District Court the Commissioner sought to justify the deduction of the amount of the legal reserve by what respondent claimed and claims is a strained, artificial and technical construction of the war excess profits tax law (quoted in the opinion of the District Court, Record, pp. 47-51).

Argument.

I.

The legal reserve is within the statutory definition of invested capital as "actual cash paid in" and "paid in or earned surplus."

This is disputed by petitioner's brief, Points I and II.

His contentions were fully met by the District Court in its opinion (Record, pp. 58-61).

The petitioner's case is based on the assumption that in Section 207 (a) (1) the words "actual cash paid in" are qualified by the words in paragraph (2) "for stock or shares." To support this he quotes from the *La Belle Iron Works* case the following words:

> "Cash paid in, and tangible property paid in other than cash are confined to such as were contributed for stock or shares in the corporation."

As that case concerned a stock corporation this was a correct paraphrase of the statute as applied to that case. There was nothing in the case calling for a construction of the act as applied to a mutual company without capital stock, and it can not be assumed that this court intended to give the words that construction when applied to a mutual company. The District Court took this view (Opinion, Record, p. 60, l. 31).

Petitioner further relied for that construction on the fact that on a later revision of the act in question subdivision (1) was amended to read "actual cash bona fide paid in for stock or shares." The fact that Congress made that revision is its own admission that the words of the prior act did not carry the implication claimed by the petitioner. The District Court took this view (Opinion, Record, p. 61, l. 3).

If the words "actual cash paid in" are by construction to be qualified by the words "for stock or shares" one

of two alternatives must be selected. Either (a) the act does not apply to mutual companies without capital stock; or (b) the word "shares" must be construed as referring to each policy-holder's interest as a member in the assets of the corporation (Opinion, Record, p. 60, l. 29).

Under the latter alternative the actual cash contributions of policy-holders to the company's assets, $70,000,000 (Record, p. 61, l. 9), would be the "actual cash paid in for shares." The remainder of the reserve, representing interest earnings, $116,000,000. would, on the Court's construction, be earned surplus. As Judge Rellstab pointed out (Record, p. 62, ll. 20-30), if the $70,000,000 of the legal reserve paid in in cash by the policy-holders was not paid in as capital it must be considered as paid-in surplus. Either of these sums credited as either paid-in capital or paid-in or earned surplus is sufficient to relieve the company of the tax assessed. The complaint (p. 8) avers that "if on any computation, plaintiff's invested capital had been ascertained at a sum in excess of $25,500,000, no war excess profits tax would have been due." As the decision in the District Court was on a motion to strike out the complaint, all averments are taken as true.

II.

The legal reserve is not such a liability as requires that it be deducted from invested capital.

The petitioner's claim to the contrary is covered under Point III of his brief (p. 10) and was disposed of by the Court in its opinion (Record, p. 47, ll. 15-20).

Petitioner's statement of the proposition involves a confusion of terms. "Assets" and "Liabilities" are not alternative terms but correlative. When stockholders pay in capital to a corporation the cash becomes "Assets" and is entered on that side of the statement. A correspond-

ing entry of capital stock is made on the other side of the statement under "Liabilities." Accumulated and undistributed earnings are entered on the "Assets" side of the account either as plant, goods or investments, and at the same time are entered on the opposite side of the account under "Liabilities" as "surplus" accruing to stockholders in addition to their item of capital stock.

So, in a mutual life insurance company, so much of the policy-holders' premiums that are reserved under the level premium system become assets and are invested and entered on the "Assets" side of the account as investments. They are also entered on the "Liabilities" side as "legal reserve." The additions thereto from interest earnings are likewise entered on the "Assets" side and on the "Liabilities" side as an addition to the legal reserve. The balance sheet therefore on the "Assets" side will show the investments, and on the "Liabilities" side the legal reserve and any additional funds retained for contingencies—in respondent's case, called contingency reserve.

By analogy to a stock corporation the legal reserve of a mutual life insurance company represents the interest of the members in the assets of the company in the same way that the capital stock and surplus of a stock corporation represent the stockholders' interests in the assets of the corporation.

The fact that in annual reports of life insurance companies the legal reserve is carried on the "Liabilities" side of the balance sheet means nothing more than above stated and does not change its character.

So long as a member lives and continues his policy his status is analogous to that of a stockholder. Like a stockholder in a building and loan association, he has a right to withdraw by discontinuing his premium payments and may then have a share of the reserve, but not before.

On a policy-holder's death his policy contract with his associates becomes a claim for a definite amount and is then for the first time converted into a debt. Until his death his interest is not that of a debtor but of a shareholder.

The foregoing outline of the relations between a policyholder and a mutual life insurance company and its assets is fully discussed and defined in an authoritative decision of the Court of Errors and Appeals of New Jersey in *Mayer* v. *Attorney General*, 32 N. J. Eq. 815.

If the insurance company becomes insolvent his interest in its assets after payment of its debts, including the policy claims of those who have previously died, becomes an ascertained claim against the receiver which may be offset against any money he owes the company by way of mortgage or otherwise. This was all that was held in *Carr* v. *Hamilton*, 129 U. S. 252.

New Jersey and some other states by statute tax life insurance companies only on the excess of their assets over their legal reserves. This is not because the reserve is a debt, but is a special statutory concession to life insurance companies to avoid oppressive and perhaps destructive taxation, for it is clear that if all of the assets of a life insurance company were taxed annually for local purposes at current rates (now four per cent.), it would absorb nearly all their interest income and disappoint the assumption on which their unchangeable premiums are based.

This legislative purpose is clearly expressed in the case cited by petitioner, *Mayor of Newark* v. *Board of Equalization*, 80 N. J. L. 258; 81 *Id.* 416, at p. 421:

> "The right given by the statute, to the company, to deduct from the amount or value of its property the amount of its liability on its policies, is, in its essence *a grant of exemption from taxation.*"

Also, in *People's Fire Insurance Company* v. *Parker*, 35 N. J. L. 575, where the Court said (p. 579):

> "The act of March 24, 1864, which relates to corporations whose business is that of insurance on lives is a peculiar statute for a favored class and the allowance of deductions for the present value of policies as a part of the liabilities of such companies * * * is certainly an exception from the general policy of the statute in taxing private corporations."

Cases on similar statutes in other states will be found to be based on the same ground, namely, a considerate indulgence to life insurance companies which would otherwise be subjected to destructive local taxation.

This legislative concession in favor of life insurance companies from the ordinary policy of statutory taxation does not justify the conclusion that the reserve is a debt that should be deducted from their invested capital in the application of the War Excess Profits Tax Law and thereby subject these companies to injurious if not destructive taxation by the Federal agencies.

It was admitted upon both arguments that fire insurance companies were in fact permitted to include their reserve funds in their invested capital. The result was that such companies, which are in business for profit, were relieved to that extent of the Excess Profits Tax, while life insurance companies, which can make no profit, were penalized by having their legal reserves deducted from their invested capital and thereby subjected to a War Excess Profits Tax.

The Commissioner's ruling was expressed in Treasury Decision No. 3153, Article 870, Regulations 45, thus:

> "The reserve funds of life insurance companies * * * can not be included in computing invested capital. The like reserve funds of insurance companies other than life insurance companies may be included in computing invested capital."

Another distinction was overlooked by the Commissioner, namely, that the reserves of fire insurance companies represent the measure of their obligations on contracts of insurance with *third parties* while in life insurance companies the legal reserve measures the interest therein of *members* of the corporation.

In further support of his claim that the legal reserve should be deducted from invested capital, petitioner (Brief, p. 9, top) asserts that the reserve is a trust fund belonging to the policy-holders.

This claim was readily disposed of by the District Court in its opinion (Record, p. 47).

There can be no doubt that the assets belong to the company. The imposition of an income tax on the company concedes that.

Nor would denomination of the legal reserve as a trust fund change its character as comprising assets constituting respondent's earning capital, whose income was subject to the ordinary income tax. The trust fund doctrine may have just application to equitable relationships, but it has never been invoked to change the ownership of corporate assets for purposes of taxation.

Whether the legal reserve be denominated a trust fund or a liability should make no difference in the decision of this case, as the contingency reserve has the same source, and is held for the same purpose, namely, to enable respondent to carry on its business of fulfilling its policy contracts. They combine to form the basis of the income that is subject to income tax. As the Court pointed out (at p. 60), the attempted segregation of the two reserve funds is unsubstantial and illogical. If one is not invested capital, neither is the other.

III.

Congressional Intent.

Petitioner seeks to infer a Congressional intent that the legal reserve should be excluded from invested capital, and this on three grounds.

First. Discussions before Congressional sub-committees.

Petitioner, at page 13, cites some hearings before Congressional sub-committees in which representatives of life insurance companies expressed their fear that the Commissioner might make an unreasonable construction of the proposed tax law. Judge Rellstab thoroughly considered these discussions and held they could have no effect upon the construction of the act in question (Opinion, Record, p. 64, l. 29, to p. 67, l. 7). His review of the testimony shows that the sub-committee evidently thought the fears were groundless.

It is interesting to note that Congress, by Sec. 243 of the Act of November 23, 1921, 42 Statutes at Large, Ch. 136, p. 261 (the first revision of the act after this tax was imposed) retroactively relieved life insurance companies of the War Excess Profits Tax for that year while retaining it for all other corporations, including fire insurance companies. This strongly implies disapproval of the Commissioner's interpretation.

Second. The exclusion of the legal reserve of life insurance companies from the capital stock tax on surplus and undivided profits imposed by Sec. 407 of the Revenue Act of 1916 (Petitioner's brief, p. 15).

This does not justify the inference that Congress meant to exclude these reserves in another act based on a different principle and for another purpose.

This distinction was clearly pointed out in the Treasury Regulations 64 of June 15, 1922 (Art. 15):

"The fair value of the capital stock, as provided under section 1000 (a) (1) of the Revenue Act of 1921, and invested capital under the excess profits tax provisions of the Revenue Act of 1921 are not necessarily the same.

"For the purpose of capital stock tax the fair value of the capital stock is estimated, and is predicated on present values, including actual appreciation of property, whether realized or unrealized, and such intangible assets as good will, trade-marks, and patents to the extent reflected by the earning power, whereas, for the purpose of excess-profits tax, the invested capital is based upon the actual investment of the stockholders in the corporation, irrespective of the present value of its assets. In the case of the capital-stock tax the fair value looks to the present net value of the assets, irrespective of the amount of the investment of the stockholders."

In the next place, the Capital Stock Tax Act, in determining the value of the capital for the purpose of that act, expressly excluded the reserves of both fire and life insurance companies. The inference from this express exclusion is that Congress assumed that otherwise the reserves of both fire and life insurance companies would be included as capital for the purposes of the Capital Stock Tax Act.

If Congress had intended to exclude the legal reserve of life insurance companies from invested capital under the War Excess Profits Tax, the inference is strong that it would have made a similar provision of exclusion in that act. The fact that it did not shows an intent to have it counted as invested capital.

Third. That the net addition to legal reserve is not subject to ordinary income tax, and that therefore the reserve was within the non-inclusion paragraph of Sec. 207 of the War Excess Profits Tax Law.

To this claim respondent answered in the courts below that the terms of the non-inclusion paragraph were intended to define the *character* of the *assets*, and not the liabilities in the balance sheet, and referred to those classes of assets the income from which was exempt from the ordinary income tax, such as stocks and tax-exempt bonds, an exception, however, being made in favor of the obligations of the United States apparently for the purpose of encouraging their purchase by corporations engaged in war industries.

In further answer, respondent pointed out that the deduction from gross income, in the year when made, of the addition to the legal reserve, indicated conclusively that Congress considered them as contributions to the capital of the corporation, particularly as the income derived therefrom would be taxed in the following years.

Respondent further claimed that if more than the current annual addition to the reserve was held to be assets not subject to tax, this would not extend to so much of the legal reserve as had been accumulated before any income tax was imposed on corporations by Congress.

Respondent's views as so outlined were sustained by the District Court, upon very thorough and careful consideration (Record, pp. 51-58). (It should be noted that in the Record, at the middle of page 56, the second word of the paragraph, "pay," is a misprint for the word "tax" used in the opinion; also that in the sixth line of page 58, the words "other than bonds" should be "and other bonds.")

The Court further demonstrated (Record, p. 62 bottom, to 63 bottom) that prior to 1909, and before the government imposed an income tax on corporations, and even before it imposed an excise tax based on annual income, respondent had accumulated a legal reserve of over $110,000,000, or more than four times the sum of $25,500,-

000, to which its invested capital would have to be reduced in order to subject it, on any construction of the act, to a war excess profits tax (Complaint, Record, p. 8, ll. 13-16); and further (on p. 64) the Court demonstrated, from Schedule "F" attached to the complaint (Record, p. 18, l. 25), that of the legal reserve held by respondent January 1, 1909, the sum of $33,569,887 had been contributed directly by policy-holders in the form of premiums.

It was thus determined that under the most favorable construction that could be claimed by the Commissioner of the non-inclusion paragraph, when applied to the respondent's financial history, no War Excess Profits Tax could be justified.

The petitioner avers, without proof, that this suit involves $25,000,000. If so, it must be that a great many life insurance companies with a smaller proportionate contingency reserve than respondent are consequently taxable at a much higher rate, as pointed out by the Court (Opinion, Record, p. 60), and so will feel much more heavily than the respondent the injustice of the Commissioner's interpretation of the act.

If respondent's contingency reserve for 1917 had happened to be $1,000,000 instead of $14,000,000, then, under the Commissioner's interpretation, respondent's war excess profits tax would have been $948,000 instead of $83,000.

Respondent therefore respectfully submits that the statute in question should not by an artificial construction be extended to cover respondent and similar companies evidently not included within its purpose and spirit, but rather the words of the statute should be given their natural signification.

Respondent company began business in 1845, with no capital or assets. On January 1, 1917, it had $198,000,000. Where did it come from if it was not paid in or earned?

We respectfully submit that the law should not be so construed as to exclude from respondent's invested capital more than ninety per cent. of its income-earning assets.

The judgment of the Circuit Court of Appeals, unanimously sustaining the judgment of the District Court. "that the legal reserve fund was invested capital within the meaning of the act" should not be disturbed, and the application for certiorari should be denied.

JOHN O. H. PITNEY,
Counsel for Respondent.

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IN THE

Supreme Court of the United States,

OCTOBER TERM, 1926.

No. 108.

CHARLES V. DUFFY, Former Collector of Internal Revenue,

Petitioner,

against

THE MUTUAL BENEFIT LIFE INSURANCE COMPANY,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT.

BRIEF FOR RESPONDENT.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1926.

CHARLES V. DUFFY, Former Collector of Internal Revenue, Petitioner,

against

THE MUTUAL BENEFIT LIFE INSURANCE COMPANY, Respondent.

No. 108

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR RESPONDENT.

Statement.

The judgment in the District Court was rendered on motion to strike out the amended complaint and upon a stipulation that the decision on that motion should finally dispose of the controversy (R. 38, 39). The allegations of the complaint must be taken as admitted.

We may direct attention to certain facts not brought out, or not emphasized, in the Government's statement of the case.

The respondent, being a purely mutual company, its policyholders constitute its members and are so described in the Company's charter (R. 2, 14). The contributions by its members since its organization, the amount returned to them, the expenses of management, and interest and other earnings are shown in Schedule A annexed to the complaint (R. 7). From this it appears that the actual cash paid in by the members of the corporation from the date of its organization to December 31, 1916, was $515,941,896.66, and the balance remaining and used in its business during the year beginning January 1, 1917 (the year in question here) was $198,712,831.17 (R. 7).

The respondent's assets are invested in its office building, and in government, municipal, railroad and utility bonds, bonds secured by mortgages on real estate, and loans to policyholders on collateral, and in foreclosed real estate as shown in Schedule B annexed to the complaint (R. 2, 7).

The average rate of interest or return on the respondent's invested assets is and for many years has been less than six per cent. per annum. None of its assets during the year 1917 yielded an income in excess of six per cent. A tabulation of the interest received in 1917 is annexed to the complaint as Schedule C (R. 2, 8).

In the respondent's management of its assets there is no segregation or special allocation of any part. They constitute one general fund. The reserve is not earmarked or separately invested (R. 3).

The net addition made each year to the respondent's reserve from the date of its incorporation to December 31, 1917, the minimum part that was derived from premiums, and the maximum derived each year from interest, with the

total reserve at the end of the year is set forth in Schedule F annexed to the complaint (R. 10).

From this it appears that of the respondent's reserve on January 1, 1917 ($186,258,796), not less than $70,302,157.10 consisted of premiums paid in by its policyholders, and not more than $115,956,638.90 consisted of interest earned on the investment of its reserve. Respondent's reserve on January 1, 1918 was $200,815,927, of which not less than $78,638,717.11 consisted of premiums paid in by its policyholders and not more than $122,177,209.89 consisted of interest earned on the investment of its reserve (R. 4, 10).

The net addition to respondent's reserve during the year 1917 was $14,557,131. Of this sum $6,220,570 arose from interest received in 1917 on assets held at the beginning of the year and $8,336,560 arose from premiums received during the year (R. 10). The interest received by the respondent in 1917 amounted to $10,130,857 (R. 8), of which only 61.402 per cent. or $6,220,570 was required for the addition to the reserve in 1917 (R. 10).

It was conceded that the respondent was entitled to have certain of its assets treated as invested capital (R. 5). But the Government, ignoring the total amount that was actually held for investment and which produced the income on which the tax was laid, to wit $198,712,831.17 (or with certain adjustments by way of additions made by the Government, $201,486,566.50 (R. Schedule H, preceding p. 11)), fixed the invested capital at only $14,719,043.76 (R. 5). This reduction left respondent's "invested capital" for the purpose of the Act at about seven per cent. of its earning assets. Allocating to this reduced amount all of the taxable income of about $1,800,000 earned by all of respondent's actual investment, the apparent income on such artificially

determined invested capital was necessarily in excess of the maximum of nine per cent. permitted by the Act and on that basis the Government computed a war excess profits tax of $83,779.70. Thus the respondent, a mutual life insurance company engaged in the endeavor to furnish to its members insurance at cost, and actually making less than six per cent. on its investment in the business, was transformed into a "war profiteer".

Manifestly, on this theory, the smaller the amount that a mutual life insurance company had accumulated over and above the assets which were equal to the "reserve" the larger the excess profits tax would be. The "invested capital" being thus reduced, the income of the Company derived from its investment would still remain large, and would relatively be so much larger that the income might easily come to 70 or 80 per cent. of the so-called "invested capital" bringing the Company into the highest brackets (up to 60 per cent.) of the tax intended as a tax upon undue war profits.

Further, it is conceded that if on any computation respondent's invested capital had been ascertained at a sum in excess of $25,500,000 no war excess profits tax would have been due. (This is owing to the statutory deduction of seven per cent. on invested capital). As the Government allowed to the plaintiff as "invested capital" the sum of $14,719,-043.76, if even approximately $10,000,000 of the assets held in reserve can be deemed to constitute invested capital, there would be no basis for the tax.